Illumination: Equity strategy and market outlook

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Global perspectives: Is the eurozone crisis really over?

- **Markets pricing in a crisis-over scenario.** The risk-on trade has continued through October. Both equity and credit markets are now at levels not seen since the start of the European sovereign debt crisis. Since highlighting the value opportunity in both January and May of this year we continue to believe investors should consider carefully where they could be taking profits.
- **The liquidity fire hose has dampened the flames which threatened to torch the global economy.** We have been surprised how effective the ECB's Outright Monetary Transactions policy has been in reducing peripheral sovereign bond yields, especially as it was originally announced in July with very little policy behind it. Spanish and Italian yields have fallen and swap spreads are back to year lows; the Baltic Dry shipping index has risen sharply in October.
- **Survey data and US housing is picking up.** In the short term, the Fed's most recent quantitative easing policy has also had the desired effect. Survey data appears to have turned in China and the US. We note that US housing construction appears to have bottomed, even if the most recent unemployment data is open to interpretation.
- **Longer term – no change to our view.** The disagreements over ECB bank supervision (a pre-condition of using ESM funds to recapitalise banks directly) are a reminder that EU policy remains ad hoc and unpredictable. We believe the austerity-without-devaluation policy is likely to cause continued trauma to economies that sign up to conditionality to access bail-out funds.
- **Debt payback is going to be a long-term theme.** Liquidity helps but solvency remains an issue for many households and governments. Even a properly-planned deficit reduction policy implies many years of fiscal drag. The link between fiscal deficits and corporate profits should not be underestimated and muted demand in Europe has been a theme of recent profit warnings.
- **Short-term markets to remain supported, 2013 remains unclear.** The rally in credit markets eases pressure in the financial sector and makes a market relapse in the short term less likely. This will encourage speculative activity, although in our view it is better to retain the discipline that enabled low-risk profits to be made in the darker days of 2012. Our focus remains on quality in terms of business franchises, cashflows and balance sheets.

Is the eurozone crisis really over?

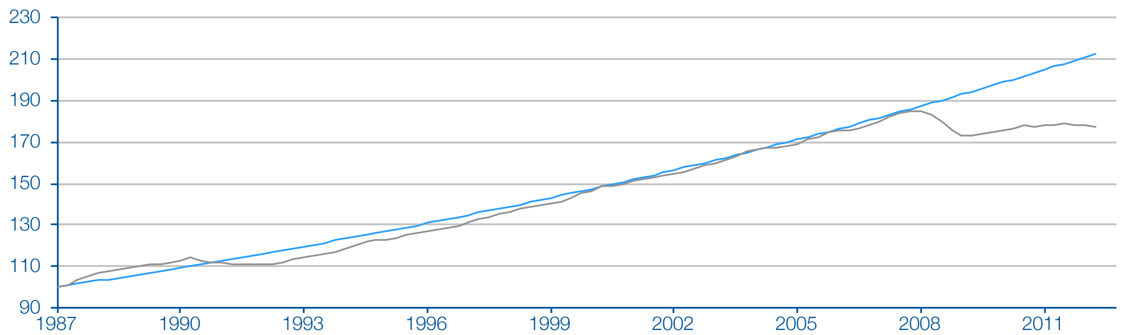
There has been a strong rally in European risk assets since June, which in part has been due to a perception that Europe will do what it takes to solve its problems. We believe this perception is wrong. For as long as national issues dominate European politics, what is good for individual member states will hold sway over what is good for Europe.

While the euro was introduced almost as a convenience for commerce and as a purely monetary concept, the economic ramifications in terms of the need for a common banking and fiscal policy are only now becoming clear to both national politicians and their electorates. Most recently this has been evidenced by disagreements over the need and timing of an EU bail-out package for Spain, as well as the German veto – for now – on the use of ESM resources for direct bank capitalisations.

To the political difficulties should be added the real concerns about whether the policy prescription of strict austerity for over-indebted European nations will be effective. Although there is a legitimate academic debate on this topic, no one is pretending that austerity is pro-growth – cutting government spending will mechanically reduce activity in the short term. The real question is whether austerity, taking into account the negative effect on activity and in the context of a fixed exchange rate regime can in the long run bring about fiscal sustainability for peripheral nations. If not, a debt restructuring would seem to be a better structural solution, even if currently a taboo for all but Greece.

For nations with their own central banks such as the UK, the solution for government funding has been to print money to finance government deficits. One benefit of this policy is that no risk premium has been priced into bond markets, thus keeping monetary policy loose at both short and long ends of the yield curve. It is notable that the ECB is now attempting to create the same effect in the European periphery through the Outright Monetary Transactions (OMT) policy.

Exhibit 1: UK deviation of real GDP from long-term trend

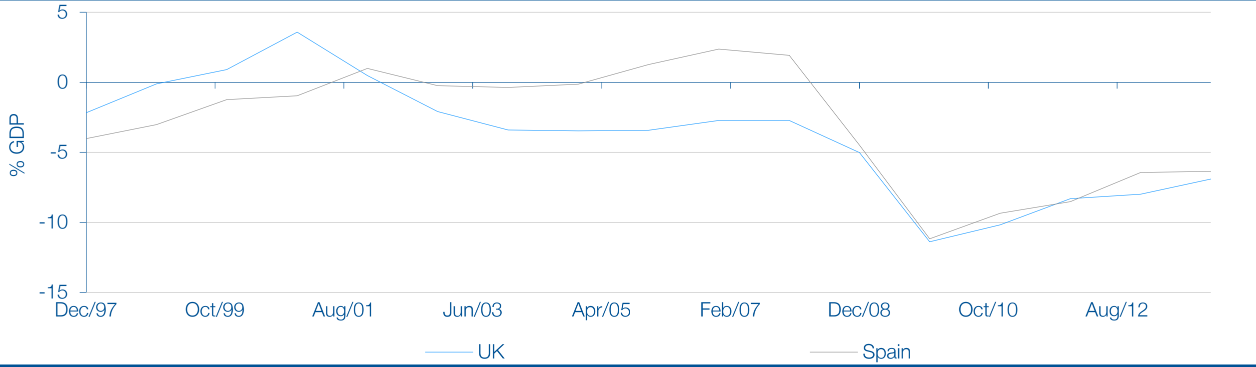


Source: Thomson Reuters Datastream

However, investors should take note that ultra-loose monetary policy in the UK has not been sufficient to close the deviation of real GDP from its long-term trend (see Exhibit 1), even as the UK's budget deficit of 8% supports economic activity. In fact, as Exhibit 2 shows, the trajectory of the budget deficit (and government debt burden) are remarkably similar for both Spain and the UK. As the UK represents a real-time experiment in the effect of an extended period of ultra-loose monetary and fiscal policy, the consequent lack of growth does not bode well for peripheral eurozone nations without those policy levers.

Despite the initial euphoria from the monetary stimulus from the ECB and US Fed, we fear the lack of sustainable growth will become evident again, potentially as early as the first quarter of 2013. Now that equity valuations are 15-20% richer compared to earlier in the year, to buy into this rally investors need to buy the growth story – and we are not so sure.

Exhibit 2: UK and Spain government budget deficits – spot the difference

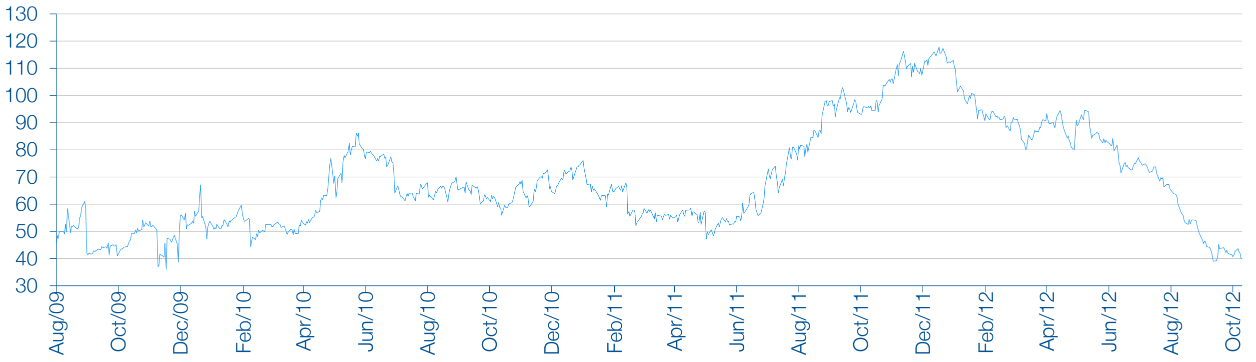


Source: Thomson Reuters Datastream

Risk on...watch the valuation starting point

Equity markets in Europe rallied by up to 20% over the summer. At the same time, measures of financial stress in the banking system such as two-year swap spreads have fallen dramatically (see Exhibit 3). Corporate credit spreads have also narrowed sharply, with the largest moves in the highest yielding and riskiest securities. There has also been a substantial reduction in Spanish and Italian bond yields (see Exhibit 4). Target2 imbalances at the Bundesbank peaked in August 2012 (see Exhibit 5).

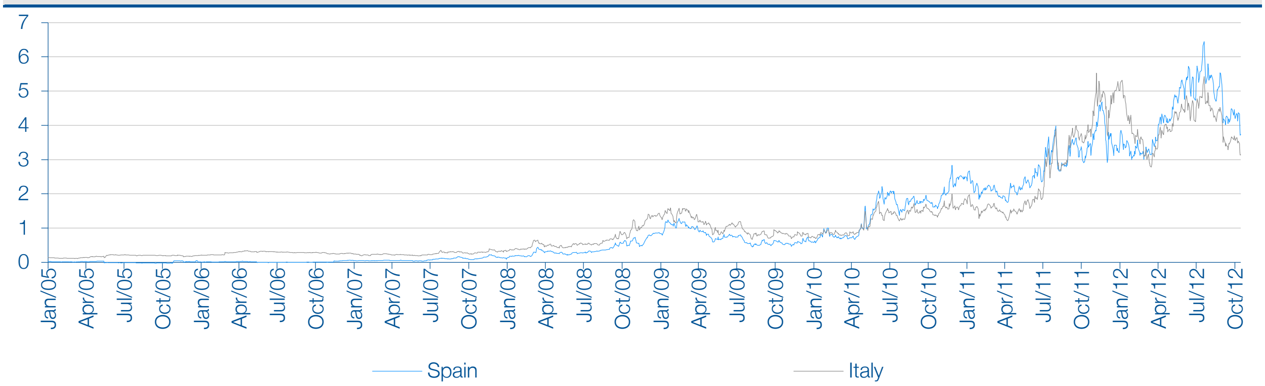
Exhibit 3: European swap spreads (bps)



Source: Bloomberg, Markit

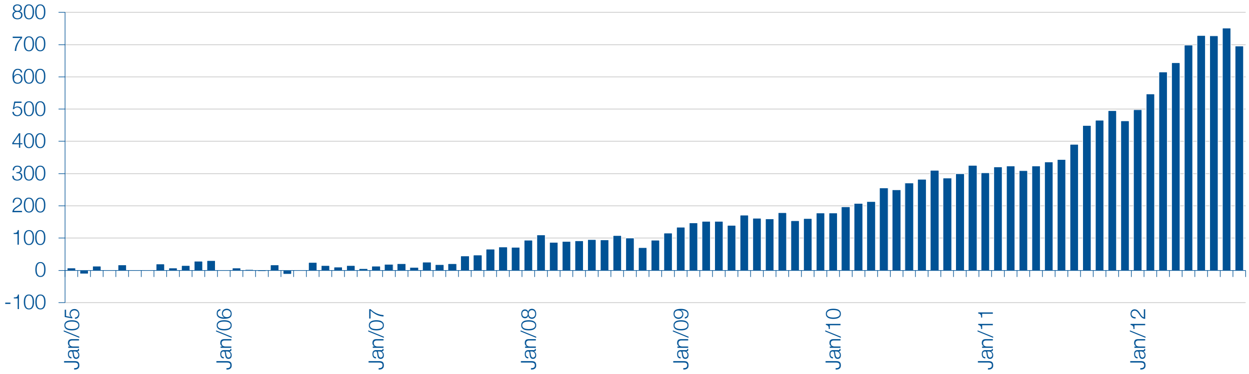
A simultaneous reduction in the price of risk across multiple asset classes is the signature of the risk-on trade. Risk-on trading and monetary stimulus have been closely linked for the last four years and the most recent episode is no different; what is different this time is the valuation starting point for equities, particularly in the US.

Exhibit 4: Government bonds – sharp declines in yield spread to bunds



Source: Bloomberg

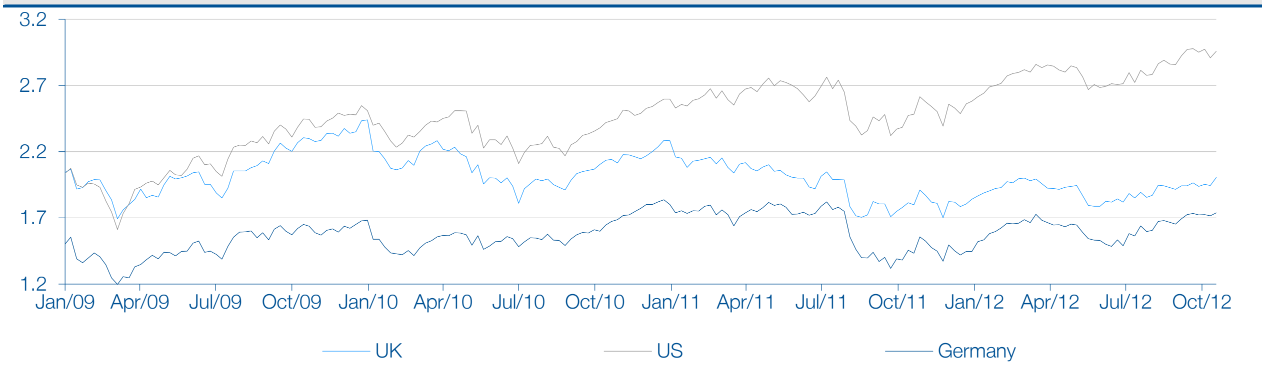
Exhibit 5: Target2 balances declined in September 2012



Source: Bundesbank

Since 2009, we believe that equity investors have rationally re-priced equities to reflect the lower growth environment. Exhibit 6 shows price/book multiples for non-financials in the UK, US and Germany. In the US, following several rounds of QE, price/book multiples have expanded to levels not seen outside the US stock market bubble of 1995-2000. There would appear to be little margin for error here. German non-financials are now trading near the top of the post-2009 trading range and UK equities are at their average for the period. As we cannot exclude the possibility of a growth disappointment by the end of the year, these are not particularly appealing levels to be fully invested.

Exhibit 6: Price/book multiples – US, UK, Germany non-financials

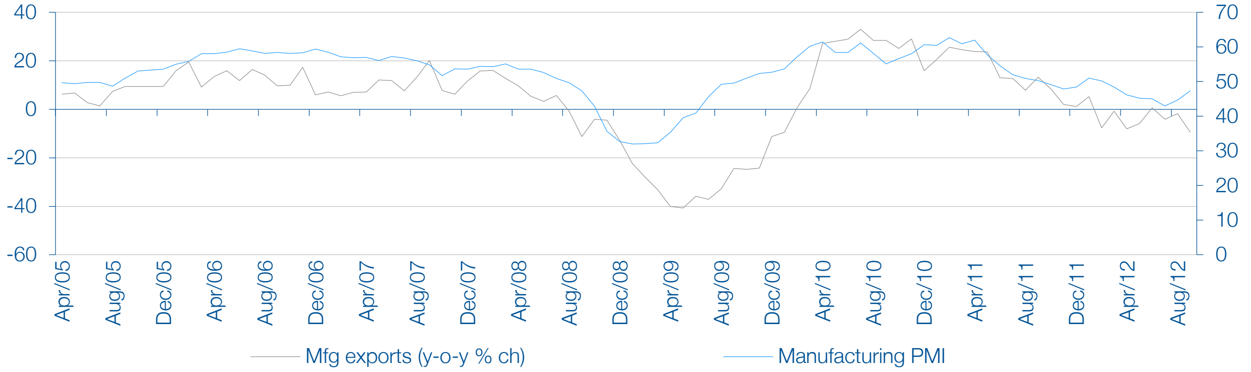


Source: Thomson Reuters Datastream

Short-term economic outlook underwritten by monetary policy

The risk-on rally proves the ECB and Federal Reserve have successfully stabilised financial markets for the short term. In addition, there has been a recovery in survey data indicating an improving level of confidence among purchasing managers. Although German export orders have declined year-on-year, we note the most recent survey data is much more optimistic and in the past, survey data has led export growth (see Exhibit 7). While survey data can be affected by swings in sentiment, hard data from the US residential construction market continues to exceed expectations while unemployment is falling. The Baltic Dry shipping index has surged since mid-year.

Exhibit 7: Germany manufacturing PMI and export growth



Source: Bloomberg

Prospects for investors in 2013 still unclear

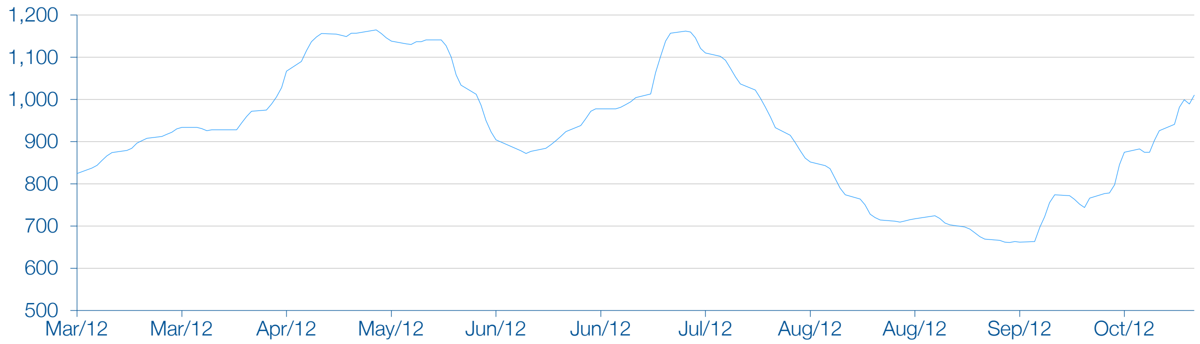
Equity investors no longer have the luxury of a valuation safety net as markets have rallied from the lows of the year. Our primary concern for 2013 is the lack of progress Europe has made towards a real solution to the problems of the periphery. Outside the eurozone, the stubbornly slow growth of nations such as the UK and US, despite aggressive fiscal and monetary policy responses, remains a key concern.

Although in the short term the ECB's announcement of the OMT policy has successfully reduced funding pressures, Spanish and Italian politicians are unlikely to apply for conditionality (ie further austerity) until forced to do so. And until conditionality packages have been agreed, the ECB will be unable to intervene in government bond markets.

While for now the mere potential for ECB intervention substantially reduced funding costs, we have been here before. Monetary policy is a temporary fix that will fade if structural solutions cannot be found. The recent disagreements over bank supervision have made the actual German position on the funding of the periphery of Europe painfully obvious.

Furthermore, logical arguments suggest that austerity without devaluation or debt restructuring will further depress economic activity in the periphery and ultimately be self-defeating. Citizens' much stronger sense of national, rather than European, identity leaves national politicians with little incentive to consider the merits of fixing the European project over more pressing national agendas.

Exhibit 8: Baltic Dry index



Source: Bloomberg

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